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Folder ID Number:	29170-006

Folder Title:
Savings and Loan Industry (1989) [1]

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THE WHITE HOUSE

WASHINGTON

January 31, 1989

MEMORANDUM FOR CHUCK HOBBS

FROM: John H. Sununu
Chief of Staff

SUBJECT: S&L Bailout

Thanks for your note. I will try and get some of your recommendations to the right people.

See you soon.

Withdrawal/Redaction Sheet
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Document No. and Type	Subject/Title of Document	Date	Restriction	Class.
01. Memo	From Charles D. Hobbs to John Sununu Re: S&L Bailout w/Tax-Free Bonds (1 pp.)	1/27/89	P/5	

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THE WHITE HOUSE

WASHINGTON

January 27, 1989

MEMORANDUM FOR GOVERNOR SUNUNU

FROM: CHARLES D. HOBBS CH

SUBJECT: S & L BAILOUT WITH TAX-FREE BONDS

Deposit insurance fees would not be a "tax" if they were voluntary (each depositor buys insurance if he wants it), which is a good idea that probably can't be sold. Political opponents will charge that such fees would remove existing protection for the "little guy" who can't afford the fees; budget watchers will complain that revenues would be unpredictable; economists will foresee reduced savings.

As an alternative to a "tax"-fee bailout and an even more onerous general revenue bailout, how about asking Congress to authorize Treasury to issue tax-free bonds for the specific purpose of beefing up the FSLIC account. Tie any actual bond issuance to a "due diligence" process through which FSLIC and the S & L industry would decide on payback methods and rates, and thus be forced as an industry to come to terms with high-risk loan practices. Establish the bond authorization as the federal government's first "capital" account, removing bond principal from the Gramm-Rudman limits, carrying the bonds in the operating budget as a wash between debt service and revenues dedicated to debt service payoff, and thus avoiding increases in the deficit because of unfunded future interest obligations.

Bank

============== FOCUS ==============

*14 POLITICAL GOLD IN S&Ls?

It's the new political hot button -- going after the S&L crooks. Once Royko pointed out that the people probably would be willing to pay a few billion more to put someone behind bars (see HOTLINE 5/29), politicians in both parties have been getting into the act. ITEM: VA Gov. Doug Wilder (in NH) proposed a national commission to investigate the scandal (see HOTLINE 6/7). (Wilder's "political guru" Paul Goldman "believes that an easily understood issue, preferably with a populist strain, is the way to voters' hearts" Donald Baker, WASHINGTON POST 6/11). ITEM: Senator John Kerry (D-MA) proposed a major Justice Deparment effort to go after international money laundering of S&L funds, done much the way illegal drug money is laundered (NY TIMES 6/1, BOSTON HERALD 6/2). ITEM: Last week 118 House members, 2/3 GOP, jumped on the bill of Rep. Peter Smith (R-VT) to create an independent counsel to "investigate the involvement of government officials" in the S&L scandal (Jerry Knight, WASHINGTON POST 6/9). ITEM: 35 House Dems, led by Rep. Stephen Neal (D-NC), moved to force the Department of Justice to devote more time/effort to go after S&L fraud. (6/9). ITEM: Sen. Tim Wirth (D-CO), Paul Simon (D-IL), Alan Dixon (D-IL), and Bob Graham (D-FL) have proposed legislation to create a new division at Justice to investigate and prosecute S&L crime. ITEM: Wirth also introduced a bill "calling on the Bush administration to request and spend the full $75 million Congress has authroized for investigation and prosecution of S&L crime in both fiscal years 1991 and 1992" (John Brinkley, ROCKY MOUNTAIN NEWS 6/8). ITEM: A group of Houston attorneys have asked Sen. Phil Gramm (R-TX), who will nominate a candidate for US Attorney by 6/15, to pick someone "who will make bank and thrift fraud prosecutions the office's No. 1 priority." (HOUSTON CHRONICLE 6/7). ITEM: Over the weekend Rep. Carlos Lucero made the S&L's a featured part of his stirring convention address that earned him enough delegate votes to challenge frontrunner Josie Heath in the CO Dem Senate primary to succeed retiring GOP Sen. Wm. Armstrong (see CO Senate).

EDITORIAL AND COLUMN OPINION remains biting. Editorial in the (Attorney General's home state) PHILADELPHIA INQUIRER: "Right now, more than 1,000 cases each involving at least $100,000 in waylaid funds are going uninvestigated. That's intolerable... it is unconscionable for the government to ensure failure by employing too few people to pursue the slimeballs." (6/6). Dave Barry in the MIAMI HERALD: "I don't want to hear any more nitpicking from you taxpayers. I don't want to hear any absurd proposals, such as that we round up all the people involved in the S&L mess, and for every million tax dollars they cost us, we sentence them to 100 hours of public service inside a closed packing crate with a 375-pound federal regulator named Bruno, whose hobbies are yodeling, intestinal malfunction and full-body massage. That would be grossly inappropriate. Fifty hours is plenty" (6/10).

Fil
S&L

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has seen

September 28, 1989

404 527-4030

Mr. John E. Robson
Deputy Secretary of the Treasury
Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Deputy Secretary Robson:

I am writing this letter at the request of Tom Healey of Goldman Sachs and for the purpose of sharing my thoughts regarding certain issues currently being discussed by the RTC. Tom has asked me to limit the length of this letter and, accordingly, I will not bore you with my background. Suffice it to say that I am a specialist who has worked with troubled financial institutions and their assets for sixteen of my twenty-one years in the practice. I was involved at the outset of both FSLIC's and the FADA's attempts to deal with this problem and am intimately familiar with the nature and results of those efforts.

Because of the necessarily general nature of this letter, I have taken the liberty of enclosing for your review and information a copy of a paper which I prepared for Richard Breeden earlier this year. Many of the issues with which you are now dealing at the RTC are discussed in much greater detail in this paper, and I believe that you will find it to be helpful as you proceed with this most formidable task. I will, however, appreciate your not copying or distributing this paper without my permission.

In response to Tom's request, please consider the following points which I believe to be of utmost importance as the RTC formulates its policies and structures for the national resolution effort:

1. <u>Nature of Problem</u>. First and foremost, it is critical that the RTC understand the nature of the problem with which it is faced. This is not a banking problem, and it is only in small part a commercial real estate problem, although it will increasingly become so over the next five years. Today, the bulk of the problem is one involving problem commercial loans backed by

real estate. Given this fact, the primary task of the RTC at the outset of the resolution effort will be to cause these problem loans to be converted to marketable earning loans or to marketable owned real estate as quickly and efficiently as possible. In the past, those responsible for the resolution effort made the mistake, initially, of equating loans backed by real estate with real estate itself. If this mistake is perpetuated as resolution mechanisms are designed by the RTC, the result will the retention of marginally useful "experts" and the creation of mechanisms, structures and approval processes that will be virtually useless for three to five years.

2. Expertise. Given the nature of the problem, at the outset of the resolution effort, the primary expertise needed by the RTC will be that of experienced creditors' rights and workout specialists. In the past, the nature of the expertise needed was not recognized and, even today, the RTC and the FDIC are staffing with retired bankers and are retaining and relying on those with a commercial real estate or commercial real estate finance background. Although pure real estate expertise and capital markets expertise will be necessary components of the national effort over time, these areas of specialty will be only marginally useful until these loans are converted to earning loans or to owned real estate.

3. Approval Processes. It is critical to the success of the resolution effort that workable approval processes be established by the RTC. With respect to sales, reasonable time periods for approvals can be tolerated. However, workouts of problem loans through adversarial negotiation demand quick and decisive decision making, often at the negotiating table. In the past, major workouts which would have saved the system millions of dollars, have fallen through because of the inability to obtain quick approval from Washington. Mechanisms must be put in place that permit workout approvals to be obtained within a twenty-four to forty-eight hour period if major workouts of problem loans are to be accomplished on behalf of the RTC.

4. National Workout Philosophy. The RTC must establish a national philosophy weighted away from the utilization of the courts and judicial processes as the primary loan resolution mechanism. Experience has proven that a negotiated, voluntary settlement, without litigation and without bankruptcy, is the most effective and efficient means of dealing with problem loan assets. For this reason, the "workout"--whether it be a true economic workout or a collateral recovery or "liquidation"

workout--generally should be the major objective of the workout specialist representing the RTC nationwide. This philosophy must be established and maintained nationally by the RTC if the resolution effort is to be successful.

5. Legal Network. The RTC must identify and utilize experienced creditors' rights and workout specialists, with proven track records, in connection with problem loan assets. Workout specialists must be distinguished from bankruptcy lawyers, commercial litigators and commercial real estate lawyers, with each being utilized only in their area of specialization. Chosen firms and specialists should follow a consistent, national workout philosophy, should be administered by a knowledgeable general counsel's staff in Washington, should meet at least quarterly for coordination purposes and should be linked by computer systems with the general counsel's office in Washington and with each other. In short, specialists must be used and carefully managed in accordance with an established resolution philosophy. Contrary to the popular belief, lawyers are not fungible in the creditors' rights and workout area. Any lawyers and law firms used solely because of their "political connections" should be used only in the more routine areas of real estate closings, title matters, etc.

6. Conflicts of Interest. If forced to make a decision today, many of the major law firms having expertise in these areas of specialty, many of the major investment banking firms, and many of the national asset management companies, would opt not to represent the RTC in the resolution effort. The initial drafts of the conflict of interest rules were so all-encompassing, that many law firms would have been disqualified merely by reason of their general counsel status for commercial banks or thrift institutions. If these rules are not narrowed appropriately to allow firms to represent the RTC with respect to one institution or problem asset portfolio, while at the same time representing an unrelated institution or an acquirer of an unrelated institution or unrelated portfolio, I believe that the RTC will run the risk of having to rely on second tier, non-specialty expertise in the resolution effort. I do not believe, however, that any firm representing the RTC in any matter should be allowed to maintain an adversarial position against the RTC in any other matter. Although these comments constitute a vast oversimplification of the problem, it clearly will be necessary to maintain some flexibility with respect to technical conflicts, if the RTC is to have available to it the services of the top firms, both legal and otherwise.

7. Title Matters. The RTC will be a major purchaser or placer of the services and protections available from the title insurance industry nationally. The title services required by the RTC will fall into two primary categories. First, the need for fast, current and accurate updates of the title status of assets and, second, the issuance of new title policies on the sale of owned real estate or the rework or sale of loans. Because title delays can have an adverse impact on both the liquidation and the rework of assets, the RTC must analyze its alternatives immediately regarding retention of necessary title services. Prior analysis of this issue during the start-up phase of the FADA indicated that the formation by the RTC of a wholly-owned title agency, qualified to do business with the major national title insurance companies, should be seriously considered as a means of minimizing the costs of necessary title services and maximizing competition for the business of the RTC. As I remember, preliminary business plans were prepared for such an agency, but there was no follow-through by the management of the FADA.

8. Grading and Sorting of Assets. Because of the nature, size and diversity of the problem portfolio of the RTC, an essential first step in the resolution process will be to "grade and sort" the assets by size and value, by asset type, by project type, by geographical market area, by earning vs. non-earning assets, and by degree of recovery difficulty for loan assets. Without a comprehensive, national classification program of this nature, the prospects for creative "pooling" of assets for sale and for dealing with the problem on a basis other than asset by asset will be greatly diminished.

9. Resolution Alternatives--RTC Assets.

A. Cash Sales. It is absolute nonsense to believe that massive cash sales of the type of assets which will be held by the RTC can be accomplished quickly. Despite the untenability of a general quick cash sale philosophy, however, certain specific classifications of assets will lend themselves to a cash sale approach in the initial stages of the resolution process. Candidates for this approach will be smaller asset classifications, particularly those with respect to which recovery cost bears an unreasonable ratio to asset size. Also, "odd-lot" classifications should be considered as candidates for auction or quick cash sale even at deep discounts. Second generation motels, putt-putt golf courses, and out-of-the-way convenience stores are a few examples of odd-lot properties that will be held by the RTC. Assets of this nature should be classified, grouped and sold at the front end of the resolution process to stop the unnecessary hemorrhaging caused by these assets, the unreasonable staffing which would be required to handle these assets, and to create early results which will help buy time, politically, to deal creatively and effectively with the bulk of the portfolio.

B. Leveraged Sales. Because of the political and economic problems incident to any broad-based program for expedited cash sales, utilization by the RTC of highly leveraged sales of asset pools, containing a blend of asset classifications, will be essential to a successful resolution program over the coming years. Leveraged sales, if structured properly, can encompass most, if not all, of the elements of the optimum resolution structure--i.e., expertise, shared value enhancement over time, quick return of capital to the system through credit enhancement of purchase money paper, and finally, shifting of the hemorrhage factor to the purchasing entity. Unfortunately, leveraged sales structures with participating features can be complex, especially in the context of pooled loans and real estate which are troubled. Many structures exist which will permit the RTC to share in upside value enhancement of the underlying real estate in the context of a leveraged sale of a pool of assets. The question is not whether such mechanisms are available, but whether complex structures of this nature can be put into place successfully in a highly politicized and bureaucratic environment.

C. Asset Management. Because of the sheer massiveness of the portfolio to be handled by the RTC, asset management contracts with private enterprise asset management companies must be an integral part of the overall resolution effort. However, contracted asset management, as well as internal asset management by RTC staff, will be only as effective as the company or individual is experienced in the handling of troubled assets. Here, as with attorneys, experience and a proven track record will be the elements critical to the successful use of contracted asset managers. In addition, asset management contracts must be structured with sufficient incentive for the asset management companies in order to ensure proper focus and attention to quick resolution and sale of the assets by those companies. In the latter stages of the resolution effort by FSLIC and the FADA, contracted asset management became a very close economic call for many asset management companies, and the results obtained by those companies eventually reflected the lack of proper incentive under their contracts.

10. Resolution Alternatives--Assets in Troubled but "Solvent" Thrifts. The RTC must not only create mechanisms to "privatize" RTC assets as quickly as possible, but also must, whenever feasible, stop the flow of additional assets into the system from liquidated institutions. Thus, a premium must be placed on dealing with potential acquirers which are willing to deal with a whole institution and not just the "good-bank" side of an institution. In addition, in troubled, but "solvent" thrifts, every effort must be made to develop techniques, short of actual liquidation, to clean up troubled thrifts, either by creating a more favorable quasi-private enterprise environment in which to accomplish resolution, or by creatively excising problem portfolios by permitting leveraged, bulk sale of these portfolios by these thrifts to preapproved purchasers with requisite capital and expertise. In short, mechanisms to stem the flow of assets into the RTC, should be thoroughly explored early on by the RTC.

Mr. Robson, the above thoughts and comments are, by necessity, very general in nature. However, if you wish to discuss any of these matters in more detail, I will be happy to arrange to stop by when I am next in the Washington area. I made many of these same comments and suggestions to the FADA when it was being formed in 1985, but it was very difficult to get anyone to stop long enough to listen and understand the nature of the problem with which they were dealing. The FADA and FSLIC experience can be invaluable to the RTC as it sets up resolution mechanisms, and I sincerely hope that you and others involved with the RTC will look closely at what has happened over the past four years and will listen to those who have long-term experience in dealing with troubled assets in financial institutions.

By the way, as I was writing this letter, I received a call from our mutual friend, Mack Taylor. Mack asked that I send his best regards to you and his condolences with respect to the burden which you have assumed at RTC!

If I can be of any further assistance to you, please do not hesitate to call.

Best regards.

Sincerely yours,

John G. Aldridge

JGA/hh
Enclosure

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January 10, 1990

CONFIDENTIAL

Mr. Daniel Kearney
President and Chief Executive Officer
Oversight Board for the RTC
1825 Connecticut Avenue, N.W.
9th Floor
Washington, D.C. 20232

Dear Dan:

I enjoyed meeting and talking with you in Washington last week and hope that our discussions were helpful to you. I have reflected on the various matters which we discussed and believe that there are a number which merit your further consideration. Each of these matters, even though preparatory in nature, could be critical to the effective management and oversight of the national resolution effort.

1. Education of Key Government Players. First, and I believe most important, were our discussions regarding the necessity to educate Congress in general, and key members of Congress and the Administration in particular, with respect to the nature of the task before the RTC and the realities of dealing with defaulted commercial loans. Both you and I know that, under the best of circumstances, the resolution effort will span many years, will cost billions of dollars to implement, will produce a perception of little progress in the initial stages, and will culminate in a bottom-line loss in the hundreds of billions of dollars. Given this reality, we must create, at the inception of the resolution effort, realistic expectations on the part of Congress, the Administration and, to the greatest extent possible, on the part of the public in general.

You will remember that, after an initial honeymoon period, the FADA was attacked on all fronts for its failure to sell assets more quickly. In fact, the vast majority of assets held by the FADA were defaulted loans which could not be sold at any price. Generally speaking, the same will be true of the RTC, and it is critical not only to the national resolution effort, but also to the very survival of the RTC, that a well-designed program for education of the key players in the resolution effort be undertaken immediately and continued throughout the resolution process. If this is not done successfully, most likely nothing else will matter because the RTC will never be allowed to complete its task.

Because the workout process generally is not well understood, and because of the political pressures arising out of the thrift industry collapse, education will not be easily accomplished. At the very least, it must entail systematic and well-planned briefings of key players and general education of the press on the realities of the effort undertaken by the RTC. The successful implementation of this education program is so important to the overall resolution effort that I would recommend to you the immediate establishment of a staff component charged only with the design and implementation of such a program.

2. Market Perception. We discussed the perception by private enterprise that it will be very difficult to consummate any deal with the RTC on realistic terms during the early stages of the resolution effort. Because of this perception, a number of major national players in the investment banking, real estate and asset management communities have made the preliminary decision to sit on the sidelines and allow "market forces to take effect". In short, they believe that resources should not be wasted in an attempt to make deals on unrealistic terms in a highly politicized, bureaucratic environment, when by spring or summer of 1991, the RTC will be forced, by a perceived lack of progress and hemorrhaging costs, to move assets into private enterprise upon the best terms available.

Because of this perception, I believe it is extremely important that a major transaction be successfully closed by the RTC no later than the summer of 1990. In my opinion, the optimum transaction would be a leveraged sale of a blended pool of owned real estate and loans in the range of $250 million, but in no event less than $100 million. If the RTC can show the markets that a deal of this nature can be done, the harmful perception discussed above will be countered by the reality of a major transaction, with the result that other major players may be enticed from the sidelines.

You mentioned during our meeting that the RTC will be in a position to show early progress through the sale of servicing portfolios, government securities and other marketable thrift assets held by the RTC. I agree with your statement and believe that sales of this nature will be important, especially to Congress, which probably will not distinguish between the types of assets sold by the RTC. However, I do believe that private enterprise markets will make this distinction and, therefore, an early leveraged sale of a blended pool of real estate and loan assets is a worthy goal for the RTC to pursue.

3. Education of RTC Workout Personnel. We discussed the fact that one of the most critical, if not the most critical, element of a successful resolution effort will be the efficiency, from a time and cost standpoint, of converting defaulted loans into salable loans or owned real estate. Although the utilization of experienced workout and creditors' rights professionals will be essential to this conversion process, equally important will be the manner in which these loan assets are handled, on a day-to-day basis, by the RTC workout personnel in the regional offices. Generally speaking, these people are not experienced in the area of loan workouts and have had little or no training in the basics of dealing with borrower tactics, adversarial negotiations, workout strategies, lender liability, etc.

Of course, as we all recognized at our meeting, it is not possible to train these people to be workout specialists. It is possible, however, to raise their level of awareness of basic workout strategies and techniques and to instill in them a fundamental understanding of workout "do's and don'ts". Because these people will occupy a critical position in the process of converting defaulted loans into salable loans and owned real estate, I strongly recommend that this basic education process be commenced immediately in each of the RTC regions and that this process continue throughout the resolution effort. For your information and by way of example, I have enclosed copies of outlines of substantive presentations of the type which I believe will be helpful to RTC personnel.

4. The "Magic Pill". Although the national resolution effort must be oriented to nonjudicial workouts if it is to be successful, even the most experienced workout specialist will lose up to thirty percent of workout efforts to the judicial system.

Because of the inexperience of the RTC workout personnel and because of the large number of defaulted loans in the RTC, we can expect this percentage to be much higher in the RTC workout effort--at the very least, fifty percent.

For this reason, we discussed the feasibility of legislation which would create a common forum for the adjudication of the thousands of claims which will be filed in the course of the national resolution effort. Of course, efforts to find a "magic pill" to simplify the recovery effort are not new. The Hudspeth doctrine was the centerpiece of the FSLIC recovery effort and was used to force borrowers to litigate their claims before a FHLBB administrative tribunal before resort to the judicial system. As you know, Hudspeth was recently deemed unconstitutional by the United States Supreme Court. Similarly, there is a "Hudspeth-like" claim process under FIRREA which has yet to be tested. Finally, other so-called "remedy shields", such as the D'Oench Duhme doctrine, are regularly utilized by the FDIC/RTC to expedite recovery and thwart borrower claims and defenses.

To date, none of these efforts to expedite the recovery effort through the use of special forums and remedy shields have materially reduced the success of borrowers delaying recovery by using the judicial process. Accordingly, as suggested by Larry Cherkis at our meeting, I do believe that efforts should be undertaken immediately to determine the feasibility of creating, through legislation or otherwise, special forums and other special remedy shields which could expedite the national recovery effort.

Dan, in addition to the four matters discussed above, I believe that there are other points touched on that need further discussion. In particular, it will be critical that the RTC create a workable approval mechanism in the workout area. Steps in the right direction have been taken by decentralizing the approval process, but there is still a long way to go. Also, the early identification of the largest defaulted loans and the placing of these loans in the hands of our top workout specialists was another thought that we should pursue further.

In any event, although our meeting was rather freewheeling, I thought that progress was made, and I look forward to continuing these discussions in the future.

Best regards.

Sincerely yours,

/s/
John G. Aldridge

JGA/hh
Enclosures
cc: Mr. Thomas J. Healey
Lawrence Cherkis, Esquire
Mr. Mark Kantor
Mr. Michael Jungman

bcc: C. Boyden Gray, Esquire

THRIFT INDUSTRY ASSET RESOLUTION
- DEALING WITH THE TUMOR

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I. INTRODUCTION

To date, the Bush Administration necessarily has directed its time and energy to the process of enacting the "Financial Institutions Reform, Recovery and Enforcement Act of 1989" ("FIRREA"), an Act designed to improve the regulatory and deposit insurance structure affecting the thrift industry, to provide through the Resolution Funding Corporation ("Refcorp"), a vehicle to raise the capital necessary for continued thrift resolution, and to create through the Resolution Trust Corporation ("RTC"), a vehicle within the government to manage resolution of insolvent thrifts and their assets. Once enacted, this legislation will represent an important first step toward insuring that a financial institutions crisis of the nature and scope of the current thrift industry crisis will not occur again. Unfortunately, with the press of the legislative process, little time has been available to deal with the most immediate problem, a problem which is growing larger by the day, and a problem which, if not dealt with quickly and creatively, has the potential politically to become "Bush's problem" within the next twelve to twenty-four months. The problem referred to is massive in size and scope and is composed primarily of non-performing commercial loans backed by real estate and, secondarily, of owned commercial real estate projects which are troubled. This problem, euphemistically referred to in this paper as the "tumor", exists in thrifts which are solvent (at least from a regulatory standpoint,) in thrifts which are insolvent, in FSLIC/FDIC receiverships and conservatorships and in corporate FSLIC/FDIC, and will in the future exist in the RTC (FSLIC/FDIC receiverships and conservatorships, corporate FSLIC/FDIC and the RTC will sometimes hereinafter be referred to collectively as the "System"). Because of the nature and size of the tumor, it must be excised quickly, efficiently and effectively. The real question is not how, because viable alternatives do exist, but instead whether it is realistic to expect that any of the more creative and effective alternatives can be implemented in such a highly politicized environment.

II. NATURE OF THE PROBLEM

Before outlining alternative solutions to this problem, it is imperative that the nature and scope of the problem be fully understood. Over the past two years, the severity of this problem has been consistently and repeatedly underestimated, primarily because of the widespread lack of understanding of the nature of the assets involved.

First, this is not a banking problem, and it will not be solved by bankers. Neither is it a regulatory problem, and it will not be solved by regulators. And today, only a small portion of the problem can be accurately characterized as a commercial real estate problem. Instead, approximately 70% to 80% of the problem lies in the area of nonperforming loans -

debts owed primarily by U.S. citizens and entities, backed by commercial real estate throughout the United States, but concentrated in overbuilt and troubled markets. Thus, the problem today can only be accurately characterized as involving for the most part creditors' rights or "workouts". The remainder (20%-30%) of the problem involves the more mundane issues of valuing and selling owned real estate. As this high percentage of loan assets is converted, over the next five years, to commercial real estate through the collateral recovery and workout process, the nature of the problem ultimately will, of course, change to one involving primarily owned commercial real estate. But today, only a portion of these troubled assets consists of owned real estate, and therefore, it would be a mistake to look to the commercial real estate industry alone to solve the problem. Top real estate expertise will be of limited use until these loan assets are converted to hard real estate. Moving forward, it is absolutely essential that the Bush Administration avoid perpetuating the potentially disastrous mistake of equating loans backed by real estate with real estate itself. If this mistake is perpetuated as resolution mechanisms are designed, the result will be the retention of marginally useful "experts" and the creation of mechanisms, structures and approval processes that will be virtually useless for three to five years.

<u>Second</u>, the tumor is enormous. Estimates of the gross dollar amount of troubled loans and owned real estate presently

in troubled thrifts and the System vary widely, but it is a safe bet that the number substantially exceeds $200 billion. Equally important in any resolution analysis is the actual number of individual assets, both loans and owned real estate. Here again, estimates vary widely, but the number could easily exceed 100,000 individual assets, excluding those consisting of residential real estate and loans backed by residential real estate. The sheer size of the problem has profound implications, both from a resolution standpoint and a market standpoint. Workout and collateral recovery processes are extremely time and cost intensive. It is not at all unusual to find that a single loan asset resolution will consume twelve to twenty-four months and hundreds of thousands of dollars in business and legal workout costs. All too often, especially in cases handled in the System, litigation and bankruptcy delay loan asset resolution for years, increasing resolution costs and reducing net recovery value. It is simply easier for a government asset manager to allow an asset to be "handled" through bankruptcy or litigation, than to risk a negotiated workout which, through 20/20 hindsight, may reflect poorly on the asset manager. In 1988 alone, FSLIC spent well in excess of $100 million on attorneys' fees in connection with its resolution efforts, and much of this undoubtedly was spent in connection with litigated matters and bankruptcy cases resulting from a "foreclose first and ask questions later" mentality. In addition to high resolution costs, loan asset resolution is enormously time consuming, demanding hands-on attention from asset management personnel. As evidenced by the FDIC experience with the Butcher bank failures, one sizeable portfolio can consume the time of hundreds of people for years, not to mention the time of outside professionals and consultants. Given the size and complexity of the current crisis, there is simply no chance that the FSLIC or the FDIC can productively and efficiently staff up to handle these assets nationwide.

Thirdly, the tumor is causing massive hemorrhaging. Commercial real estate is an active, not a passive asset, demanding constant and substantial "protective" advances of capital to preserve and maintain value. Advances of this nature are necessary whether the asset is in loan form or in the form of owned real estate. Ad valorem taxes, insurance, maintenance, security, management, legal, and other expenses must be funded merely to maintain the status quo. Estimates range as high as $100 million per day industry-wide for costs and expenses pertaining to troubled loans and real estate assets. In addition, in the so-called solvent but troubled institutions, additional monies are often advanced to borrowers simply to delay the day of reckoning and to preserve the fiction of solvency. In the vast majority of troubled institutions in the U.S. today, the tumor is growing unchecked, not because the institution is making new troubled loans, but because the institution is actively increasing the size of existing problems, both through unnecessary new advances to delay loss recognition and through necessary protective advances to preserve existing collateral value. Obviously, any solution to this crisis must minimize the impact of this hemorrhaging both on the government and on the industry itself.

<u>Fourth</u>, the resolution of troubled real estate loans through the "workout" or negotiated settlement process, as opposed to costly and time-consuming litigation and bankruptcy, demands quick, decisive, creative and experienced management. Experience over the past four years with the FSLIC and FADA resolution process has led to one unassailable conclusion - this resolution process, which will increase at least twentyfold from its current level, cannot be handled effectively and efficiently in a bureaucratic environment. In the recent past, major workouts of large problem loans have failed, simply because of cumbersome and time-consuming approval processes within the government. By the time the requisite governmental approvals are obtained, the facts and assumptions underlying a negotiated workout have often changed, not to mention the inclination of an adversarial borrower to settle voluntarily. Even with owned real estate, sales to qualified purchasers have fallen through while thousands of bid packages, demanded by Congressmen for their real estate industry constituents, were prepared and sent nationwide. While the massive bureaucratic machinery slowly grinds on, the hemorrhaging continues unchecked. Thus, the cumbersome nature of the governmental resolution process itself has, over the past few years, increased the size and severity of

the problem, as has the highly politicized environment in which resolution must take place. Again, any solution must minimize bureaucratic involvement to the greatest extent possible.

Fifth, up-front, pre-resolution valuation is very difficult, if not impossible in many cases. Experienced creditors' rights and workout professionals are essential in any loan valuation process, and even then, the margin of error can be great. The task of accurately valuing a $10 million defaulted loan - secured by a 35% occupied office building in south Florida, "appraised" at $8 million, owned by a single-purpose, bankruptcy-prone partnership with thirty-five investor limited partners, guaranteed by an individual promoter of questionable worth and character who is asserting various defenses and lender liability claims, having substantial unsecured payables, needing infusions of substantial capital for tenant improvements before occupancy can be increased, and needing additional capital infusions to remedy deferred maintenance items - is not an easy task. As evidenced by the FSLIC's experience with the sale of troubled institutions, front-end valuation either results in windfalls for the private enterprise purchasers, or broad-based government subsidies through FSLIC notes, yield-maintenance guaranties and other guaranties designed to "cover" problem loans, or both. Many of these pre-Bush Administration deals cut by the Federal Home Loan Bank Board were "lose/lose" propositions for the System, with no substantial upside even if the assets should in the future be effectively restructured and liquidated by the purchasers. Ideally, therefore, any solution must contain a realistic recovery element for the System and the taxpayers if real estate values recover sufficiently to allow recoupment of all or a substantial portion of losses incurred on these assets.

Sixth, and finally, experience has shown that the net recovery value realized through effective, creative and efficient handling of these assets by experienced workout professionals can be expected to exceed, by up to 30%, the net recovery value realized through methods which simply allow recovery processes, bureaucratic or judicial, to run their normal course. Assuming that the "tumor" will equal or exceed $200 billion, the resolution mechanisms created through the RTC, or otherwise, potentially could save $60 billion or more over the period of asset resolution. Any solution must create mechanisms which enhance the possibility of effective and efficient resolution or must place the assets in an environment in which such resolution is most likely, or both.

III. ELEMENTS OF THE SOLUTION

Given the nature and size of the tumor, it will be essential for any proposed solution to achieve as many of the following objectives as possible:

First, the resolution of the problem must be entrusted to those individuals and entities which have demonstrable and unquestioned expertise in three substantive areas of endeavor - workouts, commercial real estate and capital markets.

Most important over the resolution period will be the use of creditors' rights and workout specialists - people who have hands-on experience in resolving problem loans and who are familiar with the techniques and structures which can be utilized to expedite the recovery process. It is absolutely essential to expedite the process of converting these problem loans to earning loans or to owned real estate. Unfortunately, the number of true specialists in the workout area, both business and legal, is not great, although the sky is black with those circling the "tumor". If the Bush Administration is to be successful in dealing with this problem, it must successfully identify and utilize those specialists who understand and have a demonstrable track record in dealing with the tumor from a creditors' rights and workout standpoint.

Commercial real estate expertise will also be necessary from the beginning of the resolution process, and the need for pure real estate assistance will increase as the workout process matures and loans are converted to hard real estate assets. Given the fact that many of the major metropolitan areas in the United States are presently overbuilt and that the thrift industry crisis has had an adverse impact on many major real estate markets, there should be no shortage of quality real estate talent available to assist in the resolution of these assets over the next five to ten years.

Finally, capital markets expertise must be utilized as a part of the overall resolution process. Given the size of the problem and the number of assets involved, the "spreading" of the burden of funding the problem through pooling of asset mechanisms in the public markets will be essential, as will the creative underwriting of major asset sales by solvent, but troubled institutions. Again, we are blessed with an abundance of expertise in these areas through the quality Wall Street firms and are awash with capital availability, both domestic and foreign. These sources can be tapped, however, only if structures and mechanisms are developed which will permit this enormous pool of assets to be accessed in an economically feasible manner.

Second, in order to minimize loss to the greatest extent possible, proposed structures and alternative solutions must "buy time" to allow for reasonable recovery of real estate values, especially with respect to the upper tier or "Grade A" problem assets, and must incorporate mechanisms which will allow the System or, in the case of in-life institutions, the institution, to participate in this long-term value enhancement. Although, admittedly, the grade and quality of both borrowers and commercial real estate is lower in the thrift industry crisis than it was in the real estate crisis in the early and middle 1970's, it is still reasonable to expect substantial value recovery over time. Given the nature and size of the problem, the Bush Administration should expect that the resolution process will extend over a period of approximately 10 years, and resolution mechanisms should be structured with this time-frame firmly in mind.

Third, capital must be returned to the System as soon as possible, whether the system is the FSLIC/FDIC or solvent, troubled institutions. To accomplish this in the least burdensome and most politically palatable manner, creative credit enhancement mechanisms should be considered as a part of the overall solution in order to access public finance markets and broaden the array of debt and equity structures which can be used to buy time and spread the problem and risk over a more widely dispersed capital base. Mechanisms of this nature, which are discussed below in more detail, may prove politically preferable to the direct assistance approach which has been prevalent thus far in the resolution process. Realistically, however, it is a virtual certainty that direct assistance will continue to be necessary as a part of the resolution process, but indirect assistance mechanisms, such as credit enhancement, may reduce the amount of direct assistance needed and, therefore, some of the political fallout incident to the direct assistance approach.

Fourth, because of the high cost of holding and resolving these problem assets, the so-called hemorrhage factor must be minimized and, whenever possible, shifted entirely from the System or the troubled institution. Because these costs will continue to be carried within the System as long as the System owns the assets, creative sales structures must be explored, not only with respect to owned real estate, but also with respect to problem loans. As to the latter, it will be difficult, if not impossible, to achieve meaningful, front-end sales, except through "blended" pools which achieve acceptable diversification between earning and non-earning loans and owned real estate, and unless the Bush Administration is willing to consider sufficiently highly leveraged sales, on an exculpated basis, to lure the front-end cash, capital and expertise required for meaningful resolution. As will be discussed below, such leveraged sales structures, when combined with indirect government assistance through credit enhancement, potentially could provide a significant part of the overall resolution mosaic. Suffice it to say at this point, however, that shifting of ownership will obviously be necessary to shift the huge burden of holding and resolving these problems in a government context. The most prevalent resolution mechanism utilized to date has been contracting in private enterprise for "asset management" services. Although third party, private enterprise asset management will clearly continue to be a significant part of the overall resolution process, it must be recognized that this method can achieve only one of the elements of the optimum resolution structure - expertise. Contracted asset management does not shift the "hemorrhaging", nor does it buy time, return immediate capital to the system or spread the ultimate risk over a broad base, other than the U.S. taxpayers.

Because of the size of the tumor and its high concentration of problem loans, many different structures and alternatives will ultimately be utilized in order to maximize the net value realized from this massive loan and real estate portfolio. No one structure, sales structure or otherwise, in private enterprise or in the government, will be a panacea, and few structures, if any, will contain all of the elements outlined above. Undoubtedly, traditional government-contracted asset management, creative leveraged sales mechanisms "indirectly" assisted by the government, and direct government assistance will all be utilized in the national resolution program. But the more of the elements outlined above that a resolution alternative possesses, the better that alternative will be from a resolution standpoint. With this background in mind, an overview of available alternatives is now in order - alternatives available both to stem the flow of these assets into the System, and to deal with those assets which are now held by, and those assets which will in the future be held by, the System.

IV. AVAILABLE ALTERNATIVES - ASSETS IN THE SYSTEM

The obvious goal with respect to any asset held in the System, be it loan or real estate, will be to liquidate the asset through sale as quickly as possible with minimum adverse impact on net recovery value. To say that this is easier said than done is the height of understatement. As noted above, it is very difficult to market loan assets, particularly those embroiled in adversarial recovery proceedings. Thus, in the early stages of the resolution process, 70% to 80% of the overall System portfolio will be extremely difficult to market under the best of circumstances - a conclusion supported by the recent experiences of the FADA. In addition, certain geographical areas of the country have a disproportionate share of troubled loans and troubled real estate, particularly the southwestern United States, Colorado, the Gulf States and southern Florida. In these saturated market areas, massive sales obviously would inflict further serious damage on the real estate market or, potentially, collapse the market entirely. Finally, the FSLIC and FADA experience thus far has shown that sales are very difficult in a highly politicized environment. Qualified cash purchasers have walked away in frustration while FSLIC or the FADA complied with regulations requiring a "level playing field" for purchasers nationwide. Thousands of brochures have been prepared and sent nationwide to vocal constituents on assets which could have been sold in less time than it took to prepare the brochures and to respond to "tire kicking" respondents.

It is because of these problems and because of the nature and diversity of the portfolio that an essential first step in the resolution process will be to "grade and sort" the assets held within the System. Both loans and real estate must be sorted on a national basis (i) by size and value - e.g. $1 million and below, $1 million to $2.5 million, $2.5 million to $5 million, $5 million to $10 million, and so on; (ii) by asset type - loan or real estate; (iii) by project type - e.g. office, multifamily, retail, residential, etc.; (iv) by geographical market area; (v) by earning vs. non-earning assets; and (vi) by degree of recovery difficulty for loan assets. This sorting process will be essential to any meaningful resolution program and should be the first order of business for the RTC and its consultants. The creation of categories and programs must be accomplished through consultation with workout and creditors' rights experts who are intimately familiar with the nature of problem loan assets and recovery prospects in different areas of the country. Without a comprehensive classification program of this nature, the prospects for creative "pooling" of assets for sale and for dealing with the problem on a basis other than asset-by-asset will be greatly diminished. Once this classification system is created and functioning, three primary resolution alternatives will be available for dealing with the various asset classifications, and utilization of all of these approaches will be necessary in the overall resolution process:

A. Expedited Sales for Cash.

Currently the FDIC is "staffing up" to handle the tumor, issuing six-month cash sale guidelines and, basically, following in the footsteps of the FADA when the FADA was gearing up in 1985. The FDIC, as the FSLIC and the FADA before them, is in for a major dose of reality over the next twelve to twenty-four months. Again, the majority of System assets will be loans, most of which cannot be converted to real estate in six months, much less sold for cash in six months. Similarly, weak real estate markets and market concentrations will in many cases make the prices obtainable for owned real estate in quick cash sales so low that such sales will be both economically and politically infeasible. Some say that the inevitable result of attempting to deal with the tumor in a bureaucratic structure will be massive government giveaways and fire sales, but whether this is true or not, it is absolute nonsense to believe that massive cash sales of this type of asset can be accomplished quickly. Those that are endorsing this viewpoint simply do not understand the nature of the tumor. However, despite the untenability of a general quick cash sale philosophy, certain specific classifications of assets will lend themselves to a cash sale approach in the initial stages of the resolution process.

First, and most obvious, will be owned commercial real estate with clean title and with reasonable economic prospects -

the so-called "plums" of the national portfolio. However, an important threshold policy decision will be required with respect to this particular asset classification. Because these assets are the most marketable, they represent the best opportunity to show results, and the political pressure for results will mount dramatically as the Bush Administration's honeymoon with the tumor winds down over the next year or so. On the other hand, these more marketable assets are needed to balance and make more attractive and marketable "pools" of assets which, many believe, must be assembled and marketed given the vast size of the tumor. To effectively reduce the number of assets held by the government within a reasonable timeframe, these pools must, in other words, be "blended", with each containing a diversified mix of asset classifications including the "plum" classification. Therefore, decisions must be made early on regarding the sale of the more marketable classifications, and the Bush Administration should expect an increasing tension between the political expediency of quick sales of the more marketable assets, and the potentially adverse impact of "cherry picking" on the overall, longer term resolution process, particularly with respect to pooling mechanisms.

Second, there will be other classifications of assets, both loans and real estate, that should be considered for quick cash sale, perhaps even through public auctions similar to that conducted in Chicago in 1988 by the FSLIC. Candidates for this approach will be smaller asset classifications, particularly those with respect to which recovery cost bears an unreasonable ratio to asset size. Also, the "odd lot" classifications should be considered as candidates for auction or quick cash sale even at deep discounts. Second generation motels (a favorite of the thrift industry), putt-putt golf courses, and out-of-the-way convenience stores are a few examples of odd lot properties. Purely and simply, given the fact that the government must deal with up to 100,000 assets before the tumor is excised, it will not be feasible from a cost or time standpoint to handle odd lot assets and smaller assets on a "hands-on" basis. Assets of this nature should be classified, grouped and sold at the front end of the resolution process to stop the unnecessary hemorrhaging caused by these assets, the unreasonable staffing which would be required to handle these assets, and to create early results which will help buy time, politically, to deal creatively and effectively with the bulk of the tumor. Early sales of these particular asset classifications through auctions or similar "level playing field" mechanisms will also help create early on a sense of fairness and equity with respect to the overall resolution process.

B. <u>Leveraged Sales</u>.

Although leveraged sale mechanisms were suggested to the FSLIC and the FADA as early as 1985 as a means of moving large pools of troubled assets into the private sector, only recently have such mechanisms been given even passing consideration.

Because of the political and economic problems incident to any broad-based program for expedited cash sales, utilization by the Bush Administration of highly leveraged sales of asset pools, containing a blend of asset classifications, will be essential to a successful resolution program over the coming years. Leveraged sales, if structured properly, could encompass most, if not all, of the elements of the optimum resolution structure - i.e. expertise, shared value enhancement over time, quick return of capital to the system through credit enhancement of purchase money paper, and finally, shifting of the hemorrhage factor to the purchasing entity. Unfortunately, leveraged sales structures with participating features can be complex, especially in the context of pooled loans and real estate which are troubled. In addition, it is questionable, given the high cost of due diligence with respect to assets of this nature, that public and private syndicate purchasers would subject themselves to the relative uncertainty of the "level playing field" bidding process which has so characterized government sales procedures to date. Indeed, many observers, especially those who truly understand the nature of the tumor, are of the opinion that leveraged sales of large asset pools in a bureaucratic structure and highly politicized environment cannot and will not occur and, therefore, for private enterprise to attempt to structure and negotiate such sales will result in an enormous waste of time and resources. Instead, say these skeptics, private enterprise should wait for the inevitable fire sale or giveaway program which will occur when the losses and costs caused by the tumor become politically and economically unbearable and the System either gridlocks or collapses under the sheer massiveness of the portfolio.

Despite this skepticism, which is certainly understandable given experiences to date with the governmental resolution process, the Bush Administration must make a concerted and focused effort to devise a workable leveraged sales structure for blended pools of assets in the range of $250 million to $1 billion per pool. Only in this way will it be possible to achieve asset prices other than fire sale prices, potentially to share in long-range value enhancement of the real estate, and to reduce meaningfully carrying and resolution costs incident to these assets. If leveraged sales structures are then coupled with "indirect" government assistance through credit enhancement or through similar mechanisms, then a large part of the financed portion of the purchase price could be realized immediately through the sale of purchase money paper in the public markets.

By way of illustration only, a general outline of a prototype, leveraged, participating debt structure is set forth on <u>Addendum A</u> to this paper. Although this particular structure is a debt structure with participating, "equity-like" features, pure equity structures can likewise be utilized to effect sales of large asset pools. As a general proposition, however, debt structures will most probably become the favored structure in leveraged sales, both because of protections available under the traditional debtor-creditor relationship to the creditor-holder of the purchase money paper, and because credit enhancement mechanisms may be simpler to structure with respect to debt transactions. In any event, whatever the structure, the objective will be to move large pools of assets to well-capitalized, private enterprise purchasers with workout expertise, while retaining some long-term participatory interest which would be realized by the System if, as and when the assets are resolved and real estate markets strengthen.

As noted above, an essential element of any resolution mechanism will be the return of capital to the System as soon as possible. Thus, in any leveraged sales transaction, the purchase money paper representing the financed portion of the purchase price, whether it be debt or equity, must be structured in a manner conducive to credit enhancement and subsequent sale in public and private markets. Only in this way can the System quickly liquidate these purchase money positions and return massive amounts of capital to the System. It is true that such credit enhancement will represent continuing exposure to the System with respect to the assets sold, but the level of ultimate risk should be substantially reduced by placing these assets in the hands of well-capitalized experts in private enterprise which will have substantial incentive to maximize recovery. In a very real sense, leveraged sales structures are merely refinancings over time of the System's existing liability for the loss inherent in the assets sold, thus maximizing the opportunity for reducing or, perhaps in some cases, eliminating the ultimate bottom line loss. At least with respect to certain classifications of assets, the immediate return of substantial capital to the System through leveraged sales with indirect assistance through credit enhancement and, therefore, continuing risk of loss, will be substantially preferable, both politically and economically, to the immediate direct assistance which will be required by quick cash sales at rock bottom prices. Even if the System had the owned real estate to sell, which it does not, the tumor is simply too massive to follow a quick cash sale approach in order to "take our lumps now and get this problem behind us."

In addition to credit enhancement by the System, it may also be possible to devise a structure which will utilize the existing deposit insurance system to provide the credit enhancement necessary to refinance the existing liability over time and to spread the risk of loss over a base other than the U.S. taxpayer. Suppose, for example, that the System sells blended assets to qualified purchasers - i.e. purchasers with requisite capital and workout and real estate expertise - in a participating transaction similar to that described on Addendum A. Suppose also that the Bush Administration has caused the "Resolution Savings Bank" ("RSB") to be chartered as a special, federal savings bank for the sole purpose of assisting in the resolution process by purchasing purchase money paper obtained by the System in connection with leveraged sales of assets. RSB would attract federally insured deposits through the issuance of "Resolution Certificates of Deposit" ("Resolution CD's") which, perhaps, could have attached a "Recovery Security", representing a pass-through interest in the "upside" participatory interests purchased by RSB as a part of the purchase money debt acquired from the System. These federally insured Resolution CD's would pay market interest rates for similar deposits and would carry the upside "trailer" security as an additional bonus. Perhaps this Recovery Security would permit slightly lower than market rates to be paid on the Resolution CD's, perhaps not. But whatever the case, purchasers of these Resolutions CD's would be (i) buying a safe, federally insured investment with a market return, (ii) obtaining a stake in the recovery effort as a bonus, and (iii) helping their country by providing the funds necessary to finance a portion of the thrift industry loss over a period of time adequate to provide an opportunity for underlying real estate values to recover. Not insignificantly, the credit enhancement mechanism for this Resolution Bank structure is already in place through the current federal deposit insurance system. For illustration purposes, a diagram of the Resolution Bank structure is set forth on Addendum B to this paper.

C. Orderly Liquidation by the System.

Given the nature and size of the tumor and the experience of the FSLIC and the FADA over the past four years, it is safe to conclude that the resolution process cannot be handled effectively and efficiently in a bureaucratic environment. This is especially true with respect to real estate loans which, by their nature, demand quick, decisive and creative management - the very antithesis of the bureaucratic process in a highly politicized environment. Repeated delays, decision gridlock, self preservation and endless political interference have characterized the System's handling of what some call the "ultimate second guess business" - the workout of problem loan assets. Even with respect to owned real estate, seemingly endless government-imposed requirements designed to insure a level playing field for one and all, coupled with a layered and time-consuming approval process, have dramatically impeded the overall liquidation process for owned real estate. Purely and simply, in a highly politicized bureaucratic structure there is almost no incentive to take the risks inherent in the more creative, cutting-edge liquidation mechanisms. Indeed, such mechanisms may represent a "lose-lose" scenario for many bureaucrats - <u>i.e.</u> if they succeed they dramatically expedite the liquidation process and, if they fail, they reflect poorly on those involved. Both of these results hasten the date of joblessness and thus would run counter to the basic bureaucratic instinct of self preservation. But whatever the relative degree of success or failure thus far in the System's resolution and liquidation efforts, most observers would agree that the government does not present an environment conducive to the effective and efficient excising of the tumor. Indeed, if the

FDIC follows its historic pattern of heavy reliance on internal staff for resolution and liquidation, or if the RTC evolves into a separate, giant bureaucracy seeking to handle the hundreds of billions of dollars of troubled loans and real estate, the result will ultimately be massive gridlock, enormous resolution costs, continuing hemorrhaging and, ultimately, when public and political pressure inevitably becomes unbearable, massive government giveaways.

Despite the bleak prospect for the success of any "hands-on" resolution or liquidation effort by the System, clearly there is an essential and necessary role to be played by the System in the overall process - that of capable and expert leadership. The System must play the lead role in the bringing of true expertise to bear on the problem; the creation of a national resolution philosophy, especially with respect to loan assets; the creation of a workable approval process that will enhance, rather than hamper, the national resolution effort; the creation of bulk sale liquidation mechanisms that will expedite the overall process; the coordination and administration of the national resolution effort; the creation of the all-important "grading and sorting" process for assets; and the establishment of accountability and a result orientation for those, both within and without the System, who are responsible for the hands-on implementation of the processes utilized in excising the tumor. In short, what the nation needs is a lean, mean and expert leadership for the resolution process. What the nation does not need is an obese, timid and ordinary effort by the System to resolve the problem internally. Thus, it is the provision of leadership that should be the primary focus of the System.

At the writing of this paper, the debate continues regarding the proper roles of, and interrelationship between the RTC and the FDIC in the overall resolution process. Although there are arguments on both sides of this issue, the writer strongly believes that the all-important role of "chief executive officer" of the resolution effort should be given to a newly created, leanly staffed RTC. The RTC, as CEO, should then utilize the capacities of the FDIC with respect to those types of assets and with respect to those types of matters that lend themselves to the areas of particular expertise of the FDIC, just as the RTC will utilize the capacities of private sector asset managers and workout experts with respect to assets and matters that lend themselves to the particular expertise of these outside consultants. Both the FDIC and the FSLIC have experience and capacity that, properly utilized, can play a vital and necessary role in dealing with the tumor. But neither should be asked to do more than it is capable of handling, and neither should be asked to lead or administer the overall effort. Most importantly, the FDIC and the FSLIC should work, under contract, for the RTC and not vice versa. The FADA, though similar in concept to the RTC, was doomed to failure from the outset for many reasons - not the least of which was that the FADA was owned and controlled by the FSLIC which was intensely jealous of, and which deeply resented the FADA. Many say that the FADA was strangled by its own incompetence, but those involved in the resolution process over the past four years know that one of the hands on the FADA throat was that of the FSLIC. It is essential that the Bush Administration learn from the FADA experience as it structures the RTC/FDIC relationship. The RTC must be the CEO of the national effort, especially if, like the FADA, a private enterprise-like salary structure is to be utilized to attract reasonably capable people to the RTC.

Ideally, the RTC, if it is to be an effective CEO, should be a fairly small organization - perhaps with a staff of no more than one hundred, composed of experienced individuals from each of the necessary substantive areas of expertise - i.e. workouts and creditors' rights, commercial real estate and capital markets. Though probably not possible, an effort should be made to keep the RTC free of political cronies and favored constituents and, equally important, a pay scale competitive with private enterprise should be established in order to attract capable and experienced individuals to the RTC. Unfortunately, these objectives, though necessary and appropriate, are probably too reminiscent of the FADA to be politically feasible, but every effort should nevertheless be made to attract to the RTC quality people with the necessary substantive experience.

In order to avoid the failures of the past, the RTC should focus itself, at the outset, on three major goals. First, it should be staffed and structured to provide imaginative, capable and experienced leadership and administration, NOT to provide hands-on asset management. Second, it must establish and maintain a workable approval process, one that can respond immediately to proposed negotiated workouts and proposed sales. Third, it must establish a national philosophy weighted away from the utilization of the courts and the remedy processes as the primary loan resolution mechanism. Voluntary, negotiated settlements without litigation and without bankruptcy should be pursued wherever possible. The "foreclose first and ask questions later" mentality has created a booming business for the legal profession, but has resulted thus far in a very expensive, very time-consuming resolution mechanism for problem loans. The tumor is simply too big to excise through the courts.

In summary, cash sales for particular types of assets, leveraged sales of asset pools and individual assets, and an orderly liquidation through RTC contracts with the FDIC and FSLIC and with private enterprise asset managers, will all be necessary resolution mechanisms. The critical element to success will be, after grading and sorting the assets, to match resolution opportunities with workable resolution mechanisms. Above all, the RTC, as the leader of the national effort, must create an environment conducive to creativity and bottom-line results. To accomplish this, the RTC must be given broad power and authority over the resolution process and must be staffed with people who not only understand the tumor, but also have had hands-on experience in dealing with problem real estate loans and problem real estate assets. Purely and simply, we do not have the time for on-the-job training of the CEO of a $200-$300 billion resolution effort!

V. <u>AVAILABLE ALTERNATIVES - ASSETS IN TROUBLED, BUT "SOLVENT" INSTITUTIONS</u>

Because of the massive size of the tumor, we must not only create mechanisms to move assets now in the System out of the System and into private enterprise, but also we must, whenever feasible, stop the flow of assets into the System from liquidated institutions. As the FSLIC experience over the past four years will attest, the closing and liquidation of institutions is an extremely costly and time-consuming process. Because of this fact, every effort should be made to develop techniques, short of actual liquidation, to "clean up" troubled thrifts, either by creating a more favorable quasi-private enterprise environment in which to accomplish resolution, or by creatively excising the tumor by permitting the leveraged, bulk sale of troubled portfolios by solvent but troubled institutions to pre-approved purchasers with the requisite capital and expertise. Both of these mechanisms to stem the flow of assets into the System, which are discussed briefly below, should be thoroughly explored by the Bush Administration.

A. Pre-Liquidation Mechanisms.

In the mid-1980's, the Federal Home Loan Bank Board (the "FHLBB") created the Management Consignment Program (the "MCP") to deal with failing thrifts without resorting to the drastic measure of liquidation. The concept actually encompassed three major forms of transactions, each of which shared the common objective of providing new, and supposedly improved, management for financially troubled thrifts. The goal was to avoid further losses and imprudent transactions while providing the institution the opportunity to "clean up" the troubled portfolio in a quasi-private enterprise environment and while allowing the FSLIC to better assess the strengths and weaknesses of the institution so that a proper resolution strategy could be developed. The MCP program came to be widely criticized as a resolution mechanism primarily because of two factors. First, although the major objective of the MCP program was to provide better management for a troubled institution, rarely did the newly installed management have any expertise in dealing with a troubled real estate loan portfolio. By and large, the FHLBB installed bankers to solve this non-banking problem, with predictably little success. Most often, the newly installed management was borrowed from a healthy thrift which, by definition, was healthy because it did not have the type of assets which it was being asked to deal with in the troubled institution. In short, the requisite expertise generally was not provided through the MCP program. Secondly, shortly after the new management was put in place under the MCP program with respect to a particular institution, losses mounted dramatically and many observers wrongly attributed this to the failure of the MCP program. In fact, these losses were merely the result of new management realistically reflecting the value of the existing problem loan portfolio which had not been recognized by prior management.

In any event, the MCP program is no longer utilized today as a resolution mechanism. Supposedly, similar goals are now achieved by placing troubled institutions into a FSLIC conservatorship with the FDIC providing management pursuant to a master contract with FSLIC. Thus, just as in the MCP program, old management is displaced and new management is inserted in its stead, while the institution remains open and operating. Although similar in concept, unfortunately, the FDIC-managed conservatorships have thus far been primarily a "babysitting" service to maintain the status quo pending enactment of FIRREA, while under the old MCP program, new management teams, at least in some cases, attempted to clean up portfolios through active, aggressive resolution techniques.

Whatever the mechanism, the Bush Administration should attempt to create new devices, short of liquidation, which will permit troubled portfolio resolution and sale in a less politicized, more private enterprise-like environment. For all of their shortcomings, creative workouts of problem loan assets were more feasible under the MCP program than they were with respect to assets actually in the System. Primarily, this was attributable to the simple fact that the MCP banks could act and make decisions and give approvals and provide flexibility far better and far more quickly than could the FSLIC and the FADA. In essence, the MCP program created a more private enterprise-like environment and, thus, was much more conducive to creative, result-oriented techniques and mechanisms. Given this experience, it is imperative that some sort of similar structure be provided as part of the overall resolution effort, whether it be the FDIC-managed conservatorships or otherwise. Such structures could result in the turnaround of some of the less troubled institutions and ready them for sale at prices far greater than those which could be obtained through liquidation.

The key here, as with the entire resolution effort, will be the expertise brought to bear on the troubled portfolios of these salvageable institutions. To date, most of the "experts" placed in management positions by the FSLIC and the FDIC are bankers and others with little or no workout, creditors' rights or commercial real estate expertise. Unless this misguided practice is stopped, FDIC conservatorships will not (and should not) be more than babysitting services, and other pre-liquidation salvage mechanisms developed in the future will meet with little more success than did the MCP program.

B. <u>System Approved Troubled Portfolio Sales by Solvent Institutions</u>.

Just as there must be developed leveraged, bulk sale mechanisms to move large pools of assets out of the System into private enterprise, there must also be developed programs which will encourage solvent, but troubled thrifts to bulk sale their life-threatening troubled portfolios to System-approved, well-capitalized purchasers with the requisite expertise to maximize the net recovery value of the purchased portfolio. Generally speaking, the track record of thrifts attempting to deal with troubled loans has been horrendous. In most cases, more effort is spent by thrifts in not dealing with the problem, because dealing with the problem would force recognition of losses unacceptable to thrift management. In most troubled thrifts today, continuing losses are not being caused by the making of new troubled loans, but rather by the making of old troubled loans worse. The advancing of new money to prop up a troubled project is often much more palatable to management than is the taking of an additional loss, even though there is little or no chance that the additional monies will ever be recovered. This inherent propensity not to recognize losses and not to solve problems, when coupled with the hemorrhaging caused both in time and money with problem portfolios, has resulted in most troubled institutions moving, slowly and surely, toward certain failure and, ultimately, liquidation by the System. The lifeblood of these institutions is sucked dry while generally well-intentioned management, incapable of excising the tumor, buys time and seemingly, hope, with dollars that will never be returned.

Recently, frustrated regulators have even seized institutions while those institutions were technically solvent, obviously hoping that removal of management will cure, or at least stop the growth of the tumor. This is a very high risk pre-liquidation technique that, like the old MCP program, will only be as effective as the new, government-installed management is talented and experienced in dealing with the tumor. Changing management is not a panacea, as experience over the past four years has indisputably shown. And removing management before actual insolvency may engender stockholder and bondholder unjust seizure lawsuits for new management to deal with, in addition to the tumor. There must be better ways to deal with the solvent, but troubled institutions which are still salvageable.

Given the fact that the source of most troubled institutions' problems lies in their troubled loan and real estate portfolios, and given the fact that the vast majority of troubled thrifts cannot (both from lack of management capability and a book solvency standpoint) deal effectively with their troubled portfolios, the Bush Administration should encourage these salvageable thrifts to rid themselves of their tumor through leveraged sales to System-approved private enterprise purchasers with the capital and expertise necessary to maximize the net recovery value of the purchased portfolio. In one sense, this might be viewed as a form of "private" receivership or conservatorship, without the risks, costs and delay of a seizure by the System. Balance sheets would be cleaned up, some liquidity would be restored to the selling thrift, the tumor would be placed in the hands of a specialist with appropriate incentives to maximize recovery, the hemorrhaging would be stopped, and the thrift could return to the business of banking subject, of course, to appropriate restrictions and limitations on banking practices until full recovery is achieved.

How could this be accomplished? Both participating, leveraged debt structures similar to that outlined in Addendum A, and equity structures (utilizing preferred stock in the purchasing entity to evidence the leveraged portion of the purchase price and common stock to evidence the participating "upside" interest) could be designed to effect portfolio sales by these solvent, but troubled thrifts. Structure is not the problem, nor is capital, nor is the availability of private enterprise expertise. The problem lies in the current accounting treatment of transactions of this nature. To effect the sale of a troubled portfolio and, therefore, to excise the tumor, a thrift would have to be permitted to carry the financed portion of the purchase price, whether it be debt or equity, on its books at a level at or about the level at which it carried the assets prior to sale. If approved mechanisms were developed to allow such bulk sales to System-approved purchasers, without requiring immediate, life-threatening write-downs, many troubled institutions would have a realistic chance to return over a period of time to profitability and to avoid seizure and liquidation by the System. Such mechanisms could appropriately incorporate staged write-down requirements over time, perhaps five to ten years, unless the sold portfolio (and, therefore, the purchase money paper held by the thrift) recovered in value sufficiently to override the required write-down requirement. Obviously, staged write-downs over time is not a novel concept, and has been permitted by regulators many times in the past to give salvageable institutions the opportunity to earn their way out of trouble. Of course, the thrift management, the portfolio purchaser, and the sales structure would have to be approved by the System before the institution could qualify for this type of pre-liquidation resolution mechanism, but hopefully, standardization and streamlined approval processes would be a part of any such program created by the RTC. For every one institution salvaged, millions will be saved by the U.S. taxpayers and millions of dollars of assets will never flow into, or have to be dealt with, by the already overburdened System.

VI. CONCLUSION

As this paper is being completed, every indication from Washington is that the System, especially the FDIC, is staffing up to "handle" the tumor internally and in a hands-on manner. Hundreds of young and mostly inexperienced attorneys are being sought by the inside FDIC legal department and thousands of staff personnel are being interviewed nationwide for positions with the FDIC. If this direction is continued, a massive new bureaucracy will be created and in place within twelve to twenty-four months, about the time that the tumor officially becomes "Bush's Problem". The skeptics say that this approach by the System is inevitable - that the System is incapable of learning from the experiences of the past four years, that the lure of more government bureaucracy will be too powerful to overcome, that the tumor will again be underestimated and poorly understood, and that ultimately the newly designed national resolution program will gridlock, the political pressure will become unbearable, and massive government giveaways will be the final, inescapable consequence of the government attempting to excise the tumor in a highly politicized, bureaucratic environment. If the skeptics are correct, the final, bottom-line cost of the thrift industry crisis will be unimaginable, and the national effort to resolve the largest and most serious economic crisis since the Great Depression will have failed miserably.

Hopefully, somewhere in Washington, someone will listen and learn from those who have actually dealt with the tumor. If nothing else, in designing the national resolution effort, the Bush Administration should remember, above all, that this problem will not be solved by bankers and it will not be solved by regulators. William Seidman is, without a doubt, one of the most intelligent, most capable men in government today. But if William Seidman thinks that the FDIC can staff up to handle the tumor in a hands-on manner, he understands neither the nature nor the size of the task at hand. And if the hands-on handling of problem assets by the System becomes a major part of the national resolution effort, the skeptics will be proven correct on all counts.

OUR NATION NEEDS EXPERT LEADERSHIP IN RESOLVING THE ASSET SIDE OF THE THRIFT INDUSTRY CRISIS, IT DOES NOT NEED MORE BUREAUCRACY.

Respectfully submitted,

John G. Aldridge

ADDENDUM A

PROTOTYPE LEVERAGED SALES STRUCTURE

Before setting out a prototype leveraged sales structure, there are a number of fundamental observations that should be made with respect to this type of structure. First, many of the variables in the transaction will of necessity be driven by the nature, quality and condition of the assets to be contained in the pool. Obviously, the nature of some of the loan assets and the condition of the markets in which these assets are located are such that the assets would be impossible to dispose of in an acceptable time frame at prices which would even remotely approach the actual investment of the System in the assets. For this reason it will be necessary to price these asset pools realistically, giving the purchaser of the pools a significant economic incentive to invest its own resources, while retaining for the System a portion of the upside potential if the assets are successfully resolved and liquidated. By way of illustration only, the general parameters of a prototype leveraged sales structure are set forth below.

A. <u>Terms of Sales</u>.

1. <u>Price</u>. Acquisition prices for blended pools of assets will obviously be driven by the particular blend of asset classifications in the pool. However, as a starting point, acquisition prices would equal current fair market value of the

pooled assets, as determined by appraisal, or a relatively small discount from that appraised value.

2. Down Payment. Again, the amount of up-front cash would be determined by the blend of assets in a pool, particularly the percentage of owned real estate in a pool. Higher leverage will be required with respect to any pool containing a larger percentage of loan assets, particularly those with a greater recovery difficulty. Generally, in recognition of the fact that any pool of these assets, even a blended pool, will by definition contain troubled loans and troubled real estate, cash down payments larger than 10% to 20% of the total purchase price should not be expected. Because of the nature of these assets, the primary source of cash resulting from pooled sales will, realistically, be from credit enhancement of the purchase money paper resulting from these sales, and not from the cash down payment portion of the purchase price. At best, these are high risk assets, and high leverage will be essential to attract the expertise and capital necessary to effect sales of large pools of these assets.

3. Financing. The balance of the purchase price would be evidenced by a purchase money note, secured by first-in-priority, perfected mortgages or deeds of trust with respect to owned real estate, and by first-in-priority, perfected collateral assignments with respect to loan assets (collectively, the "Security Instruments"). The purchase money note (the "Note") would bear interest at a negotiated rate, reflecting perhaps

treasury bill rates having maturities comparable to the term of the loan and reflecting the cash flow, if any, presently being earned by the pool of assets being sold. Depending on the particular blend of the portfolio, a portion of this interest could be paid currently with the balance being accrued and paid on a priority basis to be negotiated. The Note would provide for payment, as additional interest, of a portion of the capital proceeds generated by the refinancing or disposition of the assets conveyed, on terms to be detailed in a master loan agreement, containing, among other things, the participating interest feature and creditor-type controls to be retained by the seller of the assets.

4. Term. The term of the loan would be in the range of five to ten years. In some cases, a longer term may be dictated by the properties in the pool or may be warranted if satisfactory minimum principal reductions during the latter years of the term are required.

B. Operating and Capital Reserves. The purchaser would be required to establish separate operating and capital reserves to provide funds for foreseeable operating and capital expenditures. The amount of each of these reserves would be dictated by the nature, quality and condition of the assets in the pool, but a reasonable operating, debt service and capital reserve most probably would not be less than 10% of the gross purchase price. It would be reasonable to require that some portion of the operating reserve be deposited in cash into a money market or other demand deposit account which would be pledged to the seller as additional security for the purchase money loan. The balance of these reserves could be established in the form of letters of credit or other reasonably acceptable instruments to be held by the seller, and also pledged as additional security, to be drawn upon, subject to creditor-type controls, as needed in connection with the operation, resolution and liquidation of assets within the pool.

C. Release Prices; Approval of Sales. Under a debt structure of this nature, the Security Instruments and loan agreement would provide for release mechanisms keyed to individual asset release prices in an amount equal to the greater of a negotiated dollar amount, or total net sales proceeds, less agreed priority distributions. Any sales of assets by the purchaser of the pool for less than the agreed release price would, of course, be subject to prior approval of the seller, or other holder of the purchase money indebtedness and security interest. Admittedly, agreed release prices may, in certain situations, become unworkable for any number of reasons and, therefore, in some cases, it may be necessary to provide an option on the part of the purchaser to require that the seller or purchase money debt holder either approve a sale for a reduced release price, or be required to repurchase a particular asset by canceling that portion of the remaining indebtedness originally allocated to that asset. It may also be necessary to create some sort of "put/call" mechanism, to be utilized in a limited number of situations with respect to particular assets, either as a "fail-safe" device to be implemented upon the occurrence of serious unanticipated problems with respect to a particular troubled asset (especially loans), or to give the System the ability to deal with certain sensitive matters affecting the System's operations, such as an unanticipated precedent-setting lawsuit which the System would need to control. Such a structure could also contain a mechanism pursuant to which the System could make substitutions for particular properties in certain designated situations. Obviously, the number of circumstances in which any of these mechanisms would be available would need to be expressly defined and limited.

D. Other System Controls. Given the size of the tumor and the objective of reducing the overall administrative burden on the System, the purchaser should be given a relatively free hand in dealing with and liquidating the assets within the pool. At the same time, the System cannot place these assets completely beyond its control given the high leverage nature of the structure. Therefore, it would be anticipated that the seller would insist upon reasonable "creditor-type" controls under a structure of this nature. The exact nature and extent of these controls will be dictated by the final structure of the economics of the deal, that is, by the level of risk which the seller is asked to retain in a particular transaction. Nevertheless, the optimum transaction would be one which creates as much of a traditional debtor/creditor relationship as is feasible under the circumstances.

E. Approval Process. The System would establish a creditors' committee or similar committee, composed of a small group of qualified individuals, for the purpose of dealing with release requests other than those strictly in accordance with the terms of the loan documentation and other special requests for required approvals. This creditors' committee would operate as an oversight committee, with the burden of hands-on, day-to-day handling of the portfolio having been transferred to the purchaser.

F. Warranties and Due Diligence. A leveraged pool sale would be on an "as is, where is" basis, and without representations of warranties of any kind on the part of the System. The System would be required, to the extent consistent with its responsibilities and legal constraints, to provide serious prospective purchasers full access to the assets and all information with respect to the assets, so as to permit the purchaser to make a judgment whether the assets are suitable for its purposes. The System should be required to make its personnel available to assist serious prospective purchasers in any reasonable fashion in connection with the due diligence process.

G. Application of Capital Proceeds. The application of reserves and the order of priorities among the various claims to net liquidation proceeds will be fundamental to any leveraged sale transaction. Preliminary observations as to priorities are as follows:

1. Operating costs, day-to-day costs of dealing with the management and maintenance of the assets, and all other costs incurred other than for the direct enhancement of the value of the assets, should be paid by the purchaser from a source other than funds generated by the assets themselves. This would preclude replacement of operating reserves from net capital proceeds, although the seller may be required to permit the distribution on some basis of a portion of capital proceeds for the replacement of capital reserves. Any funding of operations from capital proceeds would be tantamount to direct payment of such costs by the seller, which is inconsistent with the basic concept of the leveraged sale transaction. Because of this fact, it will be necessary to separate operating and capital reserves, and to strictly define and control the application of funds in each reserve.

2. On the other hand, it may be necessary to devise a mechanism pursuant to which capital reserves established by the purchaser could be replaced, on some reasonable basis, from capital proceeds, on the theory that such costs would inure, by reason of project value enhancement, to the seller's benefit. Of course, the seller's position on whether and the extent to which capital proceeds could be used for this purpose will depend on the extent of its participation in net proceeds and the nature of permitted capital improvements.

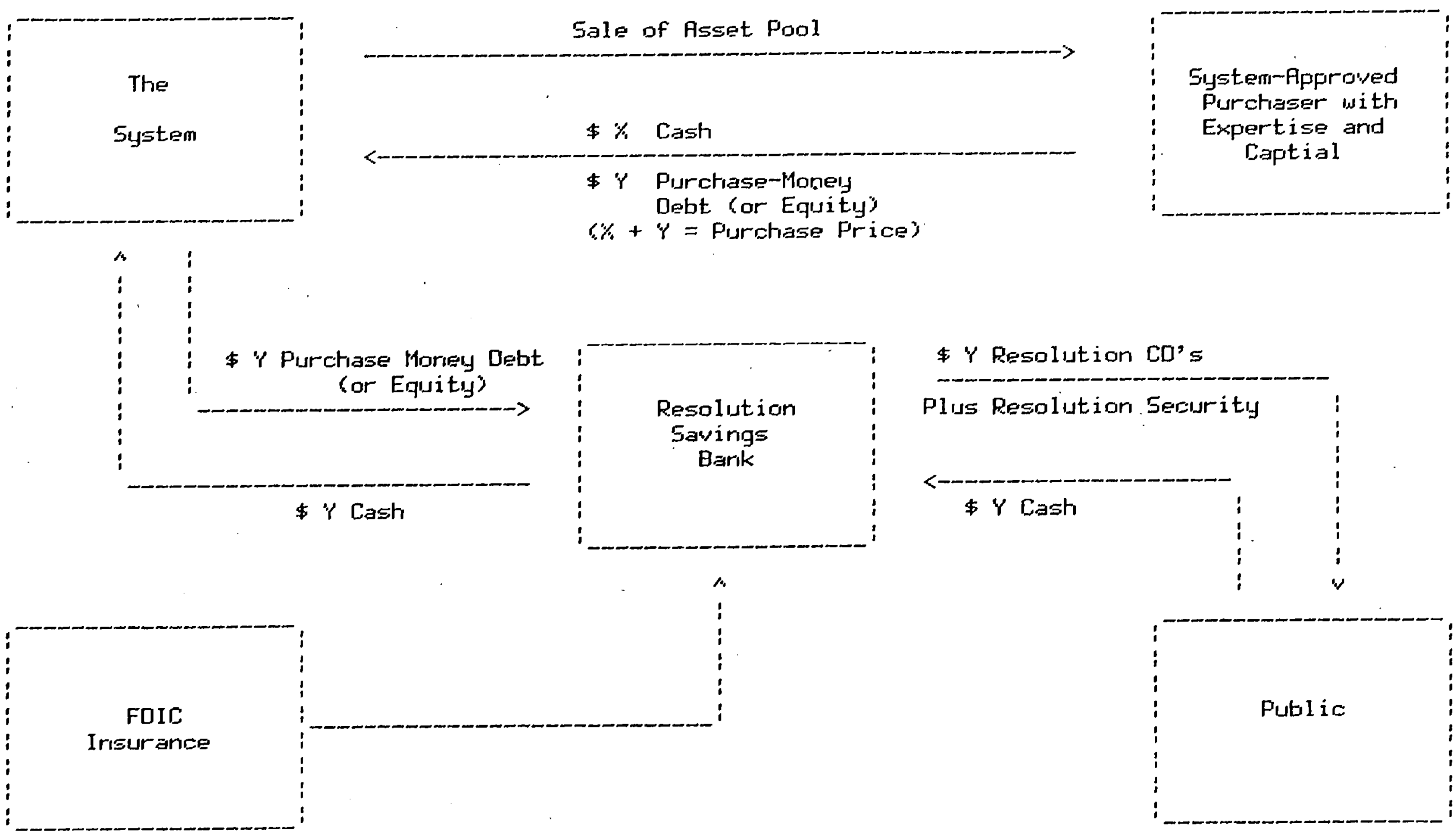
3. After replacement of capital reserves, some sort of pro rata sharing of net liquidation proceeds between the seller and purchaser would be appropriate, based on the size of the

parties' respective investments in the assets at the time of such distribution. The size of the purchaser's capital investment would be reduced, on a pro rata basis, as the principal amount of the purchase money indebtedness was reduced. It would not be acceptable for proceeds to be distributed in a manner which would remove the purchaser's risk from the transaction prior to complete liquidation, and it is essential that the purchaser's risk at all times be commensurate with its potential return.

4. After replacement of capital reserves and the return to the seller and the purchaser of amounts equal to their respective capital investments, the seller's accrued interest should be paid, after which a like return would be paid to the purchaser.

5. After both parties have been made whole and have received the negotiated returns, the percentages in which the parties would participate in any remaining net liquidation proceeds would be determined by the structure of the overall economics of the transaction. Assuming that the purchaser is asked to assume a reasonable entrepreneurial risk in a particular sale of a pool of assets, a 50/50 split of additional proceeds would seem to be appropriate. Obviously, as the level of risk to a purchaser in a particular transaction rises or falls, so should the return to the purchaser.

ADDENDUM "B"


The System
Sale of Asset Pool
System-Approved Purchaser with Expertise and Captial
$ X Cash
$ Y Purchase-Money Debt (or Equity)
(X + Y = Purchase Price)
$ Y Purchase Money Debt (or Equity)
$ Y Cash
Resolution Savings Bank
$ Y Resolution CD's
Plus Resolution Security
$ Y Cash
FDIC Insurance
Public

Withdrawal/Redaction Sheet
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Document No. and Type	Subject/Title of Document	Date	Restriction	Class.
02. Memo	From John Robson to John Sununu Re: S&L Fraud Initiatives (2 pp.)	6/8/89	P-5	

Collection:

Record Group: Bush Presidential Records
Office: Chief of Staff, White House Office of
Series: Sununu, John, Files
Subseries: Issues Files
WHORM Cat.:
File Location: Savings and Loan Industry (1989) [1]

Open on Expiration of PRA
(Document Follows)
By JP (NLGB) on 5/12/05

Date Closed: 12/3/2004	**OA/ID Number:** 29170-006
FOIA/SYS Case #: 1998-0004-F[1]	**Appeal Case #:**
Re-review Case #: 2005-0426-S	**Appeal Disposition:**
P-2/P-5 Review Case #:	**Disposition Date:**
AR Case #:	**MR Case #:**
AR Disposition:	**MR Disposition:**
AR Disposition Date:	**MR Disposition Date:**

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P-4 Release would disclose trade secrets or confidential commercial or financial information [(a)(4) of the PRA]
P-5 Release would disclose confidential advice between the President and his advisors, or between such advisors [a)(5) of the PRA]
P-6 Release would constitute a clearly unwarranted invasion of personal privacy [(a)(6) of the PRA]

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(b)(4) Release would disclose trade secrets or confidential or financial information [(b)(4) of the FOIA]
(b)(6) Release would constitute a clearly unwarranted invasion of personal privacy [(b)(6) of the FOIA]
(b)(7) Release would disclose information compiled for law enforcement purposes [(b)(7) of the FOIA]
(b)(8) Release would disclose information concerning the regulation of financial institutions [(b)(8) of the FOIA]
(b)(9) Release would disclose geological or geophysical information

J

THE DEPUTY SECRETARY OF THE TREASURY
WASHINGTON

Rec'd COS
JUN 11 1990
10:00 am

THE CHIEF of STAFF
has seen

June 8, 1990

ER

MEMORANDUM FOR CHIEF OF STAFF JOHN SUNUNU

FROM: John Robson
Deputy Secretary of the Treasury

SUBJECT: Savings and Loan Fraud Initiatives

Attached is a copy of a legislative package Treasury submitted today through OMB which has been developed to assist in the investigation and prosecution of fraud in the Savings and Loan industry. In addition, we understand that the Justice Department has been working on related proposals which will be available on Monday.

Treasury has secured through Republican Leader Dole the opportunity to offer a Savings and Loan fraud legislative package as an amendment to S. 1970, the omnibus crime bill, on which the Senate may resume consideration as soon as the middle of next week. The Administration's legislation will be folded into a package now being developed by the Republican Leader and Senator Heinz. We believe this to be a window of opportunity which we should not to let slip away.

In the Senate, a coalition of 10-12 Democrats, lead by Senators Wirth, Graham, Dixon, and now Sasser, have introduced an S and L fraud legislative proposal and have been steadily hammering the Justice Department and the Administration for failing to commit sufficient attention and resources to the investigation and prosecution of S and L crooks. In addition, Treasury has received a letter signed by over 170 Members of Congress urging the Administration to commit more energy and manpower to this area.

The Democrats have identified one aspect of the Savings and Loan scandal which they feel can be attributed to this Administration - the inability to identify and bring to justice those who were directly involved in profiting from the financial institutions. Members of both parties are increasingly hearing complaints from a broad range of voters that not enough is being done in this regard. It is clear that this has emerged as perhaps one of the top issues for the balance of this session of Congress and for the upcoming elections.

On the question of resources, our view is that the Congress will in the end thrust additional resources upon us and we may as well take credit for being out front with our own proposals. I have spoken with Ede Holiday about Treasury's ideas. In view of the time pressure, it would be important that a meeting be convened on Monday with the appropriate agencies, their legislative representatives, and representatives from OMB and the

White House. I would suggest that the discussion include reaching an agreement on a legislative package for submission to the Senate Republican Leader and the identification of other actions which can be taken by the President. I have reviewed this initiative with Secretary Brady.

Attachment: TAB A - Summary of Proposals
TAB B - Statutory Language

cc: Secretary Brady
Bill Barr
Ede Holiday

DEPARTMENT OF THE TREASURY
WASHINGTON

GENERAL COUNSEL

June 8, 1990

Dear Ms. Hale:

Please find enclosed the Department of the Treasury's proposed amendments to S. 1970, the omnibus crime bill now under consideration in the Senate. Also enclosed is a brief description of each of the proposed amendments.

The Department of the Treasury strongly believes that these amendments are necessary to enable the Federal Government to effectively investigate, prosecute and punish persons connected with the thrift industry who committed fraudulent acts or otherwise violated the laws of the United States.

In view of the anticipated imminent action on S. 1970 by the Senate, we request that the Office of Management and Budget expeditiously review and approve the transmittal of the proposed amendments to the Congress. Please contact Rick Carro, Associate General Counsel (566-2558) if you or your staff have any questions or require additional information.

Sincerely,

Jeanne S. Archibald

Jeanne S. Archibald
Acting General Counsel

Ms. Janet Hale
Associate Director for
Economics and Government
Office of Management and Budget
Executive Office of the President
Washington, D.C. 20503

Enclosures

DEPARTMENT OF THE TREASURY

SUMMARY OF PROPOSED AMENDMENTS TO S. 1970
TO COMBAT SAVINGS & LOAN FRAUD

1. Expand Secret Service Jurisdiction

This amendment expands the list of crimes that the USSS can investigate, thereby providing the USSS with concurrent jurisdiction (e.g., with FBI) to investigate crimes committed against financial institutions and the Resolution Trust Corporation. The USSS currently has no jurisdiction to investigate such crimes.

2. Request for Additional Investigatory Resources

This amendment authorizes appropriations for additional resources for the investigation of fraud and other violations of law concerning the thrift industry as follows:

U.S. Secret Service: 350 agents ($38.5 million)

Internal Revenue Service: 160 special and/or revenue agents ($16.5 million)

3. FDIC/RTC Claims

This amendment--

generally grants priority to FDIC and RTC claims over those of depositors, shareholders and other creditors in actions against directors, officers, attorneys, accountants and other S&L-related parties responsible for losses; and

consistent with the interests of justice, directs U.S. courts to give FDIC and RTC cases expedited consideration and docket priority.

4. Bank Fraud Crimes as RICO Predicates

This amendment expands the list of RICO predicate crimes to include crimes related to financial institution fraud and thereby enables prosecutors to use RICO special provisions (e.g., sentencing and forfeiture) when prosecuting corrupt banking officials and others.

5. Bar to Bankruptcy Discharge

This amendment prohibits the bankruptcy discharge of any damages, penalty, fine, forfeiture, restitution, reimbursement, indemnification, or guarantee against loss, ordered or approved by a court, issued by a Federal financial regulatory agency, or contained in any settlement agreement entered into by a debtor who committed fraud while acting in a fiduciary capacity to an insured financial institution.

6. Authority to Freeze Assets and Appoint Receiver

In order to prevent the dissipation or concealment of assets prior to judgment in court enforcement actions and civil recovery cases, this amendment--

authorizes the FDIC, RTC and OTS to seek *ex parte* Federal court orders to freeze the corporate and personal assets of defendants in civil money penalty cases and civil liability cases; and

authorizes Federal courts to appoint receivers to administer frozen assets.

7. Technical Amendments to Title 18, U.S.C.

These amendments are nonsubstantive technical and conforming provisions.

SEC. ___. ADDITIONAL AUTHORITY FOR THE SECRET SERVICE

(a) In General.--Section 3056(b)(1) of title 18, United States Code, is amended by--

(1) inserting "financial institutions, and the Resolution Trust Corporation, and concurrent with the authority of any other Federal law enforcement agency," after "land bank associations,";

(2) inserting "215," after "213,";

(3) inserting "656," after "493,";

(4) inserting "1005," after "709,"; and

(5) inserting "1341, 1343, 1344, 1512," after "1014,".

(b) Effect of Amendments.--The amendments made by this section shall not alter the authority of any other Federal law enforcement agency.

SEC. ___. ADDITIONAL INVESTIGATORY RESOURCES FOR THE SECRET SERVICE AND THE INTERNAL REVENUE SERVICE

There are hereby authorized to be appropriated--

(a) to the United States Secret Service, Department of the Treasury, to hire 350 agents, to purchase equipment, and for investigating fraud and other violations of law concerning the thrift industry (other than violations of the Internal Revenue Code of 1986): $38,500,000; and

(b) to the Internal Revenue Service, Department of the Treasury, to hire and train 160 special agents and/or revenue agents, and for investigating violations of the Internal Revenue Code of 1986 and related statutes concerning the thrift industry: $18,500,000.

SEC. ___. AMENDMENTS TO THE FEDERAL DEPOSIT INSURANCE ACT

Section 11 of the Federal Deposit Insurance Act (12 U.S.C. 1821) is amended by adding at the end thereof the following:

"(p) PRIORITY OF CERTAIN CLAIMS.--In any proceeding related to any claim acquired under section 11 or 13 of this Act against an insured financial institution's director, officer, employee, agent, attorney, accountant, appraiser, or any other party employed by or providing services to an insured financial institution, any suit, claim or cause of action brought by the Corporation shall have priority over any other such suit, claim, or cause of action asserted by depositors, creditors, or shareholders of the insured financial institution, except for claims of Federal agencies as provided in section 6321 of the Internal Revenue Code of 1986 and section 3713 of title 31, United States Code. This priority shall apply to both the prosecution of any suit, claim, or cause of action, and to the execution of any subsequent judgments resulting from such suit.

"(q) EXPEDITED PROCEDURES FOR CERTAIN CLAIMS.--

"(1) TIME FOR FILING NOTICE OF APPEAL.--The notice of any appeal of any order, whether interlocutory or final, entered in any case brought by the Corporation against an insured institution's officers, directors, employee, attorneys, accountants, or other agents shall be filed within 10 days of the entry of that order. Hearing of the appeal shall be within 30 days of filing of the notice. The appeal shall be decided within 90 days of the notice.

"(2) SCHEDULING.--Consistent with section 1657 of title 28, United States Code, the courts of the United States shall expedite the consideration of any case brought by the Corporation against an insured institution's officers, directors, employee, attorneys, accountants, or other agents. As far as practicable, the courts will give such cases priority on their dockets.

"(3) JUDICIAL DISCRETION.--Any judge may modify the schedule and limitations of paragraphs (1) and (2) as applied to a specific case, based on a specific finding that the ends of justice served by making such a modification outweigh the best interest of the public in having the case resolved expeditiously.".

SEC. ___. RACKETEER INFLUENCE AND CORRUPT ORGANIZATIONS.

Section 1961(1)(B) of title 18, United States Code, is amended--

(a) by inserting "section 215 (relating to receipt of commissions or gifts for procuring loans)," after "Section 201 (relating to bribery),";

(b) by inserting "sections 656 and 657 (relating to financial institution embezzlement)," after "473 (relating to counterfeiting),"; and

(c) by inserting "sections 1004-1007 and 1014 (relating to fraud and false statements)," after "891-894 (relating to extortionate credit transactions),".

SEC. ___. AMENDMENTS TO TITLE 11, UNITED STATES CODE

Title 11, United States Code, is amended--

(a) in section 523--

(1) by striking out "or" at the end of subsection (a)(9);

(2) by striking out the period at the end of subsection (a)(10) and inserting in lieu thereof a semicolon;

(3) by adding at the end of subsection (a) the following:

"(11) for restitution that the debtor has been ordered to pay by any court of the United States or of any State, in any criminal proceeding arising from any action that caused loss to any insured depositary institution or insured credit union; or

"(12) for any damages, penalty, fine, forfeiture, restitution, reimbursement, indemnification, or guarantee against loss, provided in any judgment, order, or consent order or decree entered in any court of the United States or of any State, issued by a Federal financial regulatory agency, or contained in any settlement agreement entered into by the debtor, arising from any act of actual fraud or defalcation while acting in a fiduciary capacity committed with respect to any insured depository institution or insured credit union."; and

(4) by adding after subsection (d) the following:

"(e) Any individual acting as a director, officer, or institution-affiliated party (as defined in section 3(u) of the Federal Deposit Insurance Act (12 U.S.C. 1813(u)) or section 206(r) of the Federal Credit Union Act (12 U.S.C. 1786(r))) of an insured depository institution or insured credit union shall be considered to be acting in a fiduciary capacity with respect to the purposes of subsections (a)(4) or (12).

"(f) Notwithstanding subsection (a)(2)(B)(iii) of this section, reliance by a creditor will not be required to establish an exception to discharge under subsection (a)(2)(A) or (B) of this section if the creditor is a financial regulatory agency that is a successor to an insured depositary institution or insured credit union.

"(g)(1) Notwithstanding any other provision of law, a complaint objecting to the discharge of any debt owed to--

"(A) an insured depositary institution or insured credit union that is closed, is in receivership or conservatorship, is sold to (or has its assets and liabilities assumed by) another insured depositary institution or insured credit union in a transaction assisted by a financial regulatory agency, or

"(B) a financial regulatory agency,

may be filed on or before the date that is the later of 120 days after the date of the debtor's first meeting of creditors, as provided under section 341 of this title, or 120 days after the date of the appointment of a conservator or receiver by a financial regulatory agency for the insured depositary institution or insured credit union with respect to which the debt arises.

"(2) The provisions of this subsection shall not extend the period of limitations prescribed by section 11(d)(4) of the Federal Deposit Insurance Act (12 U.S.C. 1821(d)(4)).

"(h) For purposes of subsections (a)(11), (a)(12), (e), (f), and (g) of this section--

"(1) the term 'insured depositary institution' shall have the same meaning as defined in section 3(c)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(2)); and

"(2) the term 'insured credit union' shall have the same meaning as defined in section 101(7) of the Federal Credit Union Act (12 U.S.C. 1752(7)).";

(b) in section 1328, by amending subsection (a)(2) to read as follows:

"(2) of a kind specified in--

"(A) section 523(a)(5) of this title; or

"(B) section 523(a)(2), (4), (6), (11), or (12) of this title owed to a financial regulatory agency, or a conservator or receiver of an insured depositary institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(2))) or insured credit union (as defined in section 101(7) of the Federal Credit Union Act (12 U.S.C. 1752(7)))."; and

(c) in section 522, by amending subsection (c)(1) to read as follows:

"(1) a debt of a kind specified in--

"(A) section 523(a)(1), (5), (11), or (12) of this title; or

"(B) section 523(a)(2), (4), or (6) of this title owed to a financial regulatory agency, or a conservator or receiver of an insured depository institution (as defined in section 3(c)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)(2))) or insured credit union (as defined in section 101(7) of the Federal Credit Union Act (12 U.S.C. 1752(7))); or".

SEC. ___. LIMITATION ON DISPOSITION OF CERTAIN ASSETS

Section 8(i) of the Federal Deposit Insurance Act (12 U.S.C. 1818(i)) is amended by adding at the end thereof the following:

"(4) In any action brought by an appropriate Federal financial regulatory agency pursuant to paragraph (1), the court may, upon application of the agency, issue ex parte a restraining order which prohibits any persons from withdrawing, transferring, removing, dissipating or disposing of any funds, assets or other property and which appoints a temporary receiver to administer such restraining order. Upon a proper showing, a permanent or temporary injunction or restraining order shall be granted without bond.".

SEC. ___. TECHNICAL AMENDMENTS TO TITLE 18, UNITED STATES CODE

Title 18, United States Code, is amended--

(a) in section 656--

(1) by inserting "bank or savings and loan holding company," before "national bank" the first time it appears in the first sentence; and

(2) by inserting "or company" after "such bank" each time it occurs in the first paragraph;

(b) in section 657--

(1) by deleting "Home Owner's Loan Corporation," and inserting in lieu thereof "Office of Thrift Supervision, the Federal Home Loan Bank System, the Resolution Trust Corporation,"; and

(2) by deleting "Federal Savings and Loan Corporation" and inserting in lieu thereof "Federal Deposit Insurance Corporation";

(c) in section 1005, by inserting "or company" after "such bank" each time it appears in the first paragraph;

(d) in section 1006--

(1) by deleting "Home Owner's Loan Corporation," and inserting in lieu thereof "Office of Thrift Supervision, the Federal Home Loan Bank System, the Resolution Trust Corporation,"; and

(2) by deleting "Federal Savings and Loan Corporation" and inserting in lieu thereof "Federal Deposit Insurance Corporation";

(e) in section 1014, by inserting "Office of Thrift Supervision" after "the Federal Home Loan Bank System,";

(f) in section 1341, by inserting ", credit," after "money"; and

(g) in section 1343, by inserting ", credit," after "money".

Sal

FSLIC and FDIC Outlays in Bush Budget

- The Bush Administration plan for resolving the thrift crisis does reduce total 1990 budget outlays for the FSLIC and the FDIC below both 1989 outlays and the 1990 outlay estimates for FSLIC and FDIC in the final Reagan budget.

- This reduction occurs even though FSLIC total 1990 spending of $31.2 billion to resolve insolvent thrifts is $3.5 billion higher than total 1989 spending and $22.1 billion above the estimated total FSLIC spending in the 1990 Reagan budget.

- The principal reason for this is that the Bush budget obtains additional non-governmental funds to finance or offset higher FSLIC spending in 1989 and 1990 primarily from two sources: a) REFCORP payments, and b) higher bank insurance premiums.

  -- The Resolution Funding Corporation (REFCORP) is a newly created, off-budget subsidiary of the privately owned Federal Home Loan Banks that will provide FSLIC $10 billion in 1989, $25 billion in 1990, and $15 billion in 1991 (a total of $50 billion). These non-governmental REFCORP funds will finance all the FSLIC spending to close or merge remaining insolvent thrifts in those years. These REFCORP funds fully offset the increased FSLIC spending in those years and thus eliminate the budget outlay that spending would have caused.

  -- higher proposed insurance premiums on commercial banks starting in 1990 increase 1990 budget receipts by roughly $.8 billion; these additional receipts offset higher FSLIC spending even though they are not used to finance that spending directly.

- Total FSLIC and FDIC budget outlays were projected to decrease $11.7 billion from 1989 to 1990 under the Reagan budget estimates:

  -- FSLIC budget outlays in the Reagan budget declined $6.6 billion from 1989 to 1990, because the excessive use of FSLIC notes to finance additional spending had adverse budget and program cost effects, and,

  -- FDIC budget outlays decreased $5.1 billion between 1989 and 1990, because FDIC estimated that its large commercial bank failures would have been resolved by the end of 1989.

- The attached chart provides net budget outlay estimates for 1989 and 1990 for the FSLIC and the FDIC in both the Reagan and Bush 1990 budgets.

  -- The Bush budget includes an additional outlay -- Treasury payments to REFCORP to help fund the interest costs on the bonds REFCORP issues to provide the funds for its payments to FSLIC.

3/16/89

Deposit Insurance Fund Outlays
($ in billions)

	1989	1990
Reagan		
FSLIC	8.7	2.1
FDIC	3.8	-1.3
Total Reagan	12.5	0.8
Bush		
FSLIC	10.7	1.4
FDIC	3.8	-2.2
Treasury REFCORP interest payments	.5	1.4
Total Bush	15.0	0.6